Merrill Lynch & Co. , Inc. & Subsidiaries v. Commissioner of Internal Revenue, 120 T. C. 12 (2003)

In a landmark tax case, the U. S. Tax Court ruled that Merrill Lynch's cross-chain sales of subsidiaries, followed by the sale of the parent companies outside its consolidated group, must be integrated as part of a single plan. This plan aimed to terminate the parent companies' ownership in the subsidiaries, resulting in tax treatment as a stock exchange rather than a dividend. The decision underscores the importance of examining the intent and structure of corporate transactions to determine their tax implications, significantly impacting tax planning strategies involving related corporations.

Parties

Merrill Lynch & Co. , Inc. & Subsidiaries (Petitioner) was the plaintiff at the trial level before the United States Tax Court. The Commissioner of Internal Revenue (Respondent) was the defendant at the trial level and the appellee on appeal.

Facts

In 1986, Merrill Lynch & Co. , Inc. (Merrill Parent), the parent of a consolidated group, decided to sell Merrill Lynch Leasing, Inc. (ML Leasing), a subsidiary, to Inspiration Resources Corp. To retain certain assets within the group and minimize tax gain on the sale, Merrill Parent executed a plan involving several steps: (1) ML Leasing distributed certain assets to Merlease, its subsidiary; (2) ML Leasing sold Merlease cross-chain to Merrill Lynch Asset Management, Inc. (MLAM), another subsidiary; (3) ML Leasing then declared a dividend of the gross sale proceeds to its parent, Merrill Lynch Capital Resources, Inc. (MLCR); and (4) ML Leasing was sold to Inspiration. The cross-chain sale was treated as a deemed redemption under section 304 of the Internal Revenue Code (IRC).

In 1987, a similar plan was executed for the sale of MLCR to GATX Leasing Corp. (GATX). MLCR sold the stock of several subsidiaries to other Merrill Lynch subsidiaries in cross-chain transactions before being sold to GATX. These transactions were also treated as deemed redemptions under IRC section 304.

Procedural History

The Commissioner issued a notice of deficiency to Merrill Lynch, disallowing the tax basis increase from the cross-chain sales, arguing that the transactions should be integrated and treated as redemptions under IRC section 302(b)(3). Merrill Lynch petitioned the U. S. Tax Court, which heard the case and rendered its decision on January 15, 2003. The Tax Court applied a de novo standard of review to the legal issues and a clearly erroneous standard to the factual findings.

Issue(s)

1. Whether the 1986 cross-chain sale of Merlease by ML Leasing to MLAM must be integrated with the later sale of ML Leasing outside the consolidated group and treated as a redemption in complete termination under IRC sections 302(a) and 302(b)(3)?

2. Whether the 1987 cross-chain sales of subsidiaries by MLCR to other Merrill Lynch subsidiaries must be integrated with the later sale of MLCR outside the consolidated group and treated as redemptions in complete termination under IRC sections 302(a) and 302(b)(3)?

Rule(s) of Law

IRC section 304 treats a sale between related corporations as a redemption. IRC section 302(a) provides that if a redemption qualifies under section 302(b), it shall be treated as a distribution in exchange for stock. IRC section 302(b)(3) applies if the redemption is in complete termination of the shareholder's interest. The attribution rules under IRC section 318 apply in determining ownership. The Court has established that a redemption may be integrated with other transactions if part of a firm and fixed plan.

Holding

The Tax Court held that both the 1986 and 1987 cross-chain sales, when integrated with the subsequent sales of ML Leasing and MLCR outside the consolidated group, qualified as redemptions in complete termination of the target corporations' interest in the subsidiaries under IRC section 302(b)(3). Therefore, the redemptions were to be treated as payments in exchange for stock under IRC section 302(a), not as dividends under IRC section 301.

Reasoning

The Tax Court's reasoning focused on the existence of a firm and fixed plan to completely terminate the target corporations' ownership interest in the subsidiaries. The Court emphasized that the cross-chain sales and subsequent sales were part of a carefully orchestrated sequence of transactions designed to avoid corporate-level tax. The Court relied on objective evidence, such as formal presentations to Merrill Parent's board of directors detailing the plans and the tax benefits expected from the transactions, to establish the existence of the plan. The Court rejected Merrill Lynch's argument that the lack of a binding commitment with the third-party purchasers precluded integration, stating that a binding commitment is not required for a firm and fixed plan. The Court applied precedents such as *Zenz v. Quinlivan*, *Niedermeyer v. Commissioner*, and others to support its decision to integrate the transactions.

Disposition

The Tax Court sustained the Commissioner's determination, integrating the cross-chain sales with the related sales of the target corporations outside the consolidated group. The decision resulted in the transactions being treated as payments in exchange for stock rather than dividends.

Significance/Impact

This case significantly impacts corporate tax planning, particularly in the context of consolidated groups and related corporations. It establishes that cross-chain sales and subsequent sales outside a consolidated group must be examined as a whole to determine their tax treatment. The decision reinforces the importance of intent and the existence of a firm and fixed plan in determining whether transactions should be integrated for tax purposes. It also underscores the need for taxpayers to carefully document and structure their transactions to achieve desired tax outcomes. Subsequent courts have cited this case in analyzing similar transactions, and it has influenced amendments to the consolidated return regulations.

